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No. 03-1495

In The Supreme Court of the United States

SUSAN MORAN, et al.,

Petitioners,

v.

J. ELLIOTT HIBBS, et al.,

Respondents.

On Petition For Writ Of Certiorari To The Supreme Court Of Arizona

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Arizona's income tax scheme uses federal adjusted gross income to compute Arizona income taxes. Federal adjusted gross income includes federal employees' mandatory retirement contributions, which are not picked up by federal employers. State employees' mandatory retirement contributions that are picked up by their employers, in contrast, are not included in federal adjusted gross income until the contributions are withdrawn or paid as retirement benefits. Does Arizona's income tax scheme violate the intergovernmental tax immunity doctrine in 4 U.S.C. § 111?

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RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondents, the Director of the Arizona Department of Revenue, J. Elliott Hibbs, and the Arizona Department of Revenue (the State), respectfully request that this Court deny the Petition for Certiorari of Susan Moran, Steve Allen, and John Udall seeking review of the Arizona Supreme Court decision in this case.

STATEMENT OF THE CASE

Petitioners ask the Court to address whether Arizona's income tax scheme violates the intergovernmental tax immunity doctrine in 4 U.S.C. § 111. They claim that Arizona discriminates against federal employees because it adopts the Internal Revenue Code, which taxes federal employees' mandatory retirement contributions while deferring taxation of state and local employees' mandatory retirement contributions that are picked up by their employers. The Arizona Supreme Court unanimously held that the Arizona income tax scheme does not discriminate against federal employees because of their source of pay and therefore does not violate the intergovernmental tax immunity doctrine. *Kerr v. Killian,* 84 P.3d 446 (Ariz. 2004) (Pet. App. 1a-22a.)

Petitioners do not provide the Court with any reason to grant review. The Arizona decision is consistent with the Court's decision in *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989), and its other precedents concerning the intergovernmental tax immunity doctrine. As Petitioners acknowledge, many other States similarly

tax mandatory retirement contributions, yet the Arizona decision does not conflict with any other federal or state court decision.

Statutory Background.

In 1979, Arizona adopted federal adjusted gross income as the starting point for computing Arizona taxable income. 1978 Ariz. Sess. Laws, ch. 213, § 2. The current statute provides that "'Arizona gross income' . . . means the individual's federal adjusted gross income for the taxable year, computed pursuant to the internal revenue code." Arizona Revised Statutes (A.R.S.) § 43-1001(2) (Supp. 2003). In 1979, the Arizona Legislature also amended Arizona income tax law to allow state and local employees to deduct mandatory retirement contributions from their adjusted gross income. 1978 Ariz. Sess. Laws, ch. 213, § 2 (codified at A.R.S. § 43-1022(2) (Supp. 1978)). At that time, Arizona also allowed persons to deduct all benefits received from mandatory state and local retirement plans. A.R.S. § 43-1022(3) (Supp. 1988).

In 1985, the Arizona Legislature authorized two of the state retirement plans (the Arizona State Retirement Plan [ASRS] and the Elected Officers Retirement Plan [EORP]) to "pick up" employee contributions to conform with the requirements of Internal Revenue Code (I.R.C.) § 414(h)(2). Section 414(h)(2) provides that if a state or local governmental employer pays (or "picks up") employee contributions to a retirement plan qualified under I.R.C. §§ 401(a) or 403(a), "the contributions so picked up shall be treated as employer contributions." Both contributions are taxed when the employee plan pays benefits to the

employee instead of when the contributions are made to the retirement plan. (Pet. App. at 3a, 7a.)

In 1989, this Court held that Michigan violated the intergovernmental tax immunity doctrine by taxing federal retirees' retirement benefits while exempting state retirees' retirement benefits. *Davis*, 489 U.S. at 817. The Arizona Legislature responded to *Davis* by amending A.R.S. § 43-1022(3) to remove the deduction for benefits received from state and local retirement plans. 1989 Ariz. Sess. Laws, ch. 312, § 12. The Arizona Legislature also amended A.R.S. § 43-1022 to eliminate the deduction for mandatory contributions to ASRS, EORP, and county and city retirement plans. *Id.* In 1991, the Legislature eliminated the deduction for mandatory contributions to two other state retirement plans, the Correctional Officer Retirement Plan (CORP) and the Public Safety Personnel Retirement System (PSPRS). 1991 Ariz. Sess. Laws, ch. 155, § 8.

In 1999, the Legislature authorized PSPRS to pick up employee contributions (1999 Ariz. Sess. Laws, ch. 50, § 4 & ch. 327, § 22), and PSPRS elected to pick them up in 2000 (Pet. App. 7a). In 2000, CORP also elected to pick up employee contributions. (Pet. App. 7a.)[1] Thus, from 1989 to 2000, the state and local employees in CORP and PSPRS paid taxes on their mandatory contributions to these plans. *(Id.* at 8a.)

Federal employees are covered by retirement plans that Congress has adopted. Before 1987, federal employees participated in the Civil Service Retirement System (CSRS). (I.R.A. 140.) Employee contributions to the CSRS

[1] The Legislature authorized CORP to pick up employee contributions in 1986. 1986 Ariz. Sess. Laws, ch. 325, § 1.

are included in the employee's federal adjusted gross income and are subject to federal[2] and to Arizona[3] income tax at the time of the contribution.

In 1986, Congress adopted the Federal Employees Retirement System (FERS) to replace CSRS for employees hired after 1983. 5 U.S.C. § 8402, *added by* Pub. L. No. 99-335, title I, § 101(a), 100 Stat. 521 (1986). FERS is a three-tier plan consisting of Social Security benefits, a basic benefit plan (annuity), and a thrift savings plan. 5 U.S.C. § 8403 (Social Security); 5 U.S.C. § 8415 (basic annuity); 5 U.S.C. § 8437 (thrift savings plan). Employee contributions to the basic benefit plan are included in the employee's federal adjusted gross income and are subject to federal[4] and to Arizona[5] income tax. Federal employee contributions in the thrift savings plan are not included in federal adjusted gross income and therefore are not subject to federal[6] or Arizona[7] income tax until the contributions are withdrawn or paid as retirement benefits.

Proceedings Below.

Petitioners, current federal employees and Arizona taxpayers, initiated this litigation in 1989 as an administrative action requesting tax refunds. Although the case originally involved claims for refunds for taxes paid on federal retirement benefits and contributions to federal

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[2] 5 U.S.C. § 8334(b).

[3] A.R.S. §§ 43-1001(2) to -1099.

[4] 5 U.S.C. § 8422(b).

[5] A.R.S. §§ 43-1001(2) to -1099.

[6] 5 U.S.C. § 8440(a)(2).

[7] A.R.S. §§ 43-1001(2) to -1099.

retirement plans before 1991, current and former federal employees, including Petitioners, received refunds for Arizona taxes paid on retirement benefits and contributions before 1991. (Pet. App. at 10a [noting that Arizona's Governor directed the Arizona Department of Revenue "to make refunds for the tax years from 1985 to 1990 to all taxpayers who had filed timely refund claims"].) In addition to the question of class certification that has been remanded to the trial court and is not at issue here, all that remains is the issue presented here—i.e., Petitioners' claim that they are entitled to refunds for taxes paid on mandatory retirement contributions after 1990. (Pet. App. at 12a.)

As to that issue, the Arizona Court of Appeals initially held that "Arizona's income taxing scheme applicable to tax years 1991 to the present does not violate 4 U.S.C. § 111 to the extent it taxes federal employees' mandatory contributions to retirement plans, but not those of certain state and local employees." *Kerr v. Killian*, 32 P.3d 408, 417 (Ariz. App. 2001) (*Kerr IV*)[8] (Pet. App. at 69a.) The court reasoned that "Arizona's taxing scheme . . . distinguishes not between state and federal employees, but rather between all those whose employers make or pick up their mandatory

[8] There are three earlier published opinions that address either Petitioners' related 42 U.S.C. § 1983 litigation or another issue in Petitioners' refund litigation: *Kerr v. Waddell*, 899 P.2d 162 (Ariz. App. 1994) (Pet. App. 107a-153a) (*Kerr I*) (holding in Petitioners' 42 U.S.C. § 1983 case that Arizona's income tax scheme violated the intergovernmental tax immunity doctrine); *Kerr v. Waddell*, 916 P.2d 1173 (Ariz. App. 1996) (Pet. App. 88a-106a) (*Kerr II*) (dismissing Petitioners' 42 U.S.C. § 1983 claims for failure to exhaust administrative remedies and vacating *Kerr I*); and *Kerr v. Killian*, 3 P.3d 1133 (Ariz. App. 2000) (Pet. App. 74a-88a) (*Kerr III*) (addressing attorneys' fees issue in Petitioners' administrative refund action).

retirement contributions and all those whose employers do not." (Pet. App. at 63a).

The Arizona Court of Appeals reconsidered the holding in *Kerr IV* and found that it "sprang from a narrow, mistaken application of the literal language of 4 U.S.C. § 111." *Kerr v. Killian*, 65 P.3d 434, 440 (Ariz. App. 2003) (*Kerr V*) (Pet. App. at 36a). The court found that the practical effect of Arizona's taxing scheme was to require federal employees to pay Arizona income tax on their mandatory contributions to retirement plans while "effectively excusing most state and local governmental employees from paying such taxes on their own mandatory contributions to their corresponding state or local governmental retirement plans." (Pet. App. at 37a.) Because the court did not find any significant differences between the two classes of taxpayers, it held that Arizona's income tax scheme violated 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine. (Pet. App. at 41a.)

The Arizona Supreme Court vacated the portion of the court of appeals amended opinion that held that "the application of [A.R.S.] § 43-1001(2) to [Petitioners] violated the intergovernmental tax immunity doctrine codified in § 111." (Pet. App. at 21a.)[9] The court found that A.R.S.

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[9] Petitioners erroneously assert in their Statement of the Case that the State's Petition for Review in the Arizona Supreme Court was "jurisdictionally untimely." (Pet. at 6.) The State filed its Petition for Review thirty days after the court of appeals issued its amended opinion. This filing was timely under Rule 23(a) of the Arizona Rules of Civil Appellate Procedure. The Arizona Supreme Court therefore denied Petitioner's Motion to Dismiss Petition for Review that raised the timeliness issue. Arizona Supreme Court Order of October 29, 2003. In any event, failure to file a timely petition for review is not jurisdictional. *See* Rule 5(b) of the Arizona Rules of Civil Appellate Procedure ("The time for doing any of the acts provided in these rules, by order of

(Continued on following page)

"§ 43-1001(2) contains no overt discrimination against any taxpayer because of the source of pay," noting that "[e]very Arizona taxpayer, whether employed by the federal government, the State, a political subdivision, or a private employer, begins with federal AGI [adjusted gross income] as the Arizona tax base." (Pet. App. at 16a.) The court also examined the "practical operation" of A.R.S. § 43-1001(2) as *Phillips Chemical Co. v. Dumas Independent School District*, 361 U.S. 376, 383 (1960), and *Barker v. Kansas*, 503 U.S. 594, 604-05 (1992), require. (Pet. App. 17a-18a.) The court concluded that the practical operation "does not require that federal employees be taxed differently than state employees with respect to mandatory retirement contributions" because (1) Arizona taxes state and local employees' contributions to retirement plans that have not been picked up by their employers the same as it treats federal employees' contributions to retirement plans; and (2) the distinction in the treatment of the contributions is not based on the source of the income but on "whether a particular governmental employer has voluntarily opted to pick up the employee contributions and treat them as employer contributions." (Pet. App. at 18a.)

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the court, or by any applicable statute, may be shortened or extended by the court upon stipulation or upon motion, for good cause shown, but the court may not shorten or extend the time for filing a notice of appeal.").

REASONS TO DENY THE PETITION

1. The Arizona Supreme Court Decision Does Not Conflict with Relevant Decisions of This Court.

Petitioners incorrectly argue that the Arizona Supreme Court decision is contrary to *Davis* and *Barker* and is inconsistent with this Court's other precedents. The Arizona Supreme Court correctly determined that A.R.S. § 43-1001(2), which adopts federal adjusted gross income as the starting point for computing Arizona taxes, does not facially discriminate against federal employees. Therefore, the decision is not contrary to *Davis* or *Barker*, which hold that such facial discrimination violates 4 U.S.C. § 111.[10] The Arizona Court further correctly determined that the practical operation of A.R.S. § 43-1001(2) does not require discriminatory treatment of federal employees. The decision therefore is consistent with the Court's precedents that requires lower courts to examine the practical operation of a challenged tax scheme to ascertain whether the tax scheme discriminates based on the source of the compensation or pay. The Court should therefore deny review.

a. Unlike the Tax Schemes in *Davis* and *Barker*, A.R.S. § 43-1001(2) Does Not Facially Discriminate Against Federal Employees.

In *Davis*, the Court held that Michigan's income tax scheme violated the intergovernmental tax immunity

[10] Section 111(a) provides: "The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation."

doctrine codified in 4 U.S.C. § 111. Michigan's Income Tax Act explicitly exempted from taxation the retirement benefits that Michigan and its political subdivisions paid, but levied an income tax on retirement benefits that all other employers, including the federal government, paid. 489 U.S. at 817. The Court noted that it was "undisputed that Michigan's tax system discriminate[d] in favor of retired state employees and against retired federal employees." *Id.* at 814. The Court therefore concluded without analysis that the discrimination would violate § 111 unless "'justified by significant differences between the two classes.'" *Id.* at 815-16 (quoting *Phillips Chemical Co.*, 361 U.S. at 383). The Court did not find that either of Michigan's proffered reasons justified its discriminatory treatment and held that the petitioner was entitled to a tax refund. *Id.* at 817.

Like the Michigan income tax scheme addressed in *Davis*, the Kansas income tax scheme challenged in *Barker* overtly discriminated against some federal retirees: "The State of Kansas taxes the benefits received from the United States by military retirees but does not tax the benefits received by retired state and local government employees." *Barker*, 503 U.S. at 596. The Court therefore only addressed the Kansas Supreme Court's determination that significant differences between military retirees and state and local government pensioners justified the discrimination. *Id.* at 598. The Court reversed because it found that the lower court based its determination that the discrimination was justified on an erroneous characterization of military retirement benefits as current compensation for reduced current services. *Id.* at 605.

The Arizona Supreme Court correctly noted that both *Davis* and *Barker* concerned income tax schemes that

facially discriminated against federal employees and that this Court therefore concluded in those cases that the challenged tax schemes discriminated because of the federal source of pay. (Pet. App. at 16a.) The Arizona court then correctly found that the Arizona income tax law challenged here, A.R.S. § 43-1001(2), which uses federal adjusted gross income to compute Arizona income taxes, is different from the tax schemes that *Davis* and *Barker* addressed: "A.R.S. § 43-1001(2) contains no overt discrimination against any taxpayer because of the source of the pay." (Pet. App. at 16a.)

Petitioners only obliquely address the Arizona court's distinction between the Arizona income tax scheme challenged here and the tax schemes in *Davis* and *Barker*. They argue that the court's "suggestion that Ariz. Rev. Stat. § 43-1001(2) (2004) contains no overt discrimination is untenable." (Pet. at 12 n.9.) But Petitioners do not point to any overt discrimination in the language of the statute and instead discuss what they claim is the tax provision's practical operation—i.e., "if a taxpayer is not an employee of the state or one of its local subdivisions, the employees cannot qualify for the favored treatment." *Id.* This Court rejected a similar argument in *Jefferson County v. Acker*, 527 U.S. 423, 442-43 (1999). It held that a facially nondiscriminatory Alabama occupational tax exempting those who held licenses under other state or county laws did not violate § 111, even though the plaintiff federal judges could never qualify for an exemption, because the tax did "not discriminate against federal judges in particular, or federal officeholders in general, based on the federal *source* of their pay or compensation." Because the Arizona decision correctly distinguished between the facial discrimination that the Court addressed in *Davis* and *Barker*

and the facially neutral statute at issue here, it is not contrary to those decisions.

b. The Practical Operation of A.R.S. § 43-1001(2) Does Not Require that Federal Employees Be Taxed Differently than State Employees with Respect to Mandatory Retirement Contributions.

Petitioners argue that the court below applied the wrong test by suggesting that "the intergovernmental doctrine applies only to statutes that discriminate on their face against a federal interest" and that the substance of the Arizona scheme violates the intergovernmental tax immunity doctrines under this Court's precedents. (Pet. at 12.) Petitioners are wrong as to both arguments.

In determining whether there is a violation of the intergovernmental tax immunity doctrine, the Court examines the "practical operation" of the challenged tax scheme. *Phillips*, 361 U.S. at 383; *see also Jefferson County*, 527 U.S. at 439 (to determine whether a tax fits within the allowance in § 111, the Court examines the "practical impact, not the State's name tag."). But examining the practical operation of the taxing scheme does not mean that any state tax that has a disparate impact on federal employees is invalid. Section 111 only prohibits taxation that discriminates "on the basis of the source" of the compensation. *Davis*, 489 U.S. at 817; *see also Jefferson County*, 527 U.S. at 442-43 (finding that the challenged tax did not discriminate against federal employees "based on the federal source of their pay or compensation").

Contrary to Petitioners' implication, the court below did not stop its analysis after it found that the Arizona scheme did not facially discriminate against federal employees. Instead, the court acknowledged that if there was no facial discrimination in § 43-1001(2), it must examine the "'practical operation' of the Arizona scheme." (Pet. App. at 17a [citing *Phillips*, 361 U.S. at 383].) Nor did the court ignore this Court's admonition in *Jefferson County* that courts must look past form to substance. The court correctly concluded that the practical operation of A.R.S. § 43-1001(2) "does not require that federal employees be taxed differently than state employees with respect to mandatory retirement contributions." (Pet. App. at 18a.) The court's conclusion was based on the Arizona statutes' neutral operation. The court first noted that "Arizona taxes the employee contributions of those state employees whose contributions have not been picked up by their employers in precisely the same fashion as it treats the employee contributions of federal employees." (Pet. App. 18a.)

Petitioners do not address the court's finding that the fact that many state and local government employees paid current state tax on mandatory retirement contributions indicates that the Arizona scheme is not a cloak for discrimination. Instead, they argue that the Legislature's failure to remove the exemption for retirement contributions from the statutes governing the ASRS and EORP retirement plans demonstrates its discriminatory intent, even though it removed the deductions from the income tax statutes. (Pet. at 13.) The lower court explained the Legislature's failure to remove these exemptions: "Presumably, the legislature did not remove the exemption of the member contributions in 1989 in light of the preexisting pick ups under § 414(h)(2) by ASRS and EORP." (Pet.

App. 7a n.6.) In addition, the timing of the Legislature's enactment of A.R.S. § 43-1001(2) and of the legislation authorizing ASRS and EORP to pick up employee contributions, both of which predate the *Davis* decision and the Legislature's reaction to it, undermine Petitioners' suggestion that A.R.S. § 43-1001(2) was a cloak for discrimination.

The lower court also found that the Arizona scheme was neutral in practical operation because nothing in the scheme "discriminates between taxpayers based on the federal or non-federal source of income; the distinction is instead based on whether a particular governmental employer has voluntarily opted to pick up the employee contributions and treat them as employer contributions." (Pet. App. at 18a.) This finding is consistent with the interpretation of § 111 in *Davis* and *Jefferson County*.

Petitioners argue that the lower court's rationale defies this Court's precedents because it requires Congress to cure the State's discrimination. (Pet. at 9.) Petitioners' argument misconstrues the lower court's rationale. The court correctly recognized that the federal government has always had the option to pick up employee contributions and that it can exercise that option at any time "through its legislative branch," but that it has not yet chosen to do so. (Pet. App. at 19a.) Instead, Congress has adopted FERS, a three-tiered plan that includes mandatory retirement contributions that are subject to tax at the time of the contribution but also gives federal employees the option of making deferred contributions to a thrift savings plan. Congress has apparently chosen the plan that suits the federal government's needs at this time instead of opting to pick up mandatory employee contributions. Thus, the Arizona Supreme Court correctly concluded that

Arizona's treatment of Petitioners' employee contributions is not a "necessary consequence of their federal status" and that it therefore does not violate the intergovernmental tax immunity doctrine. (Pet. App. 19a.)

Finally, Petitioners are wrong in arguing that the Arizona decision is inconsistent with *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983), and *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992). *Memphis Bank* involved a facially discriminatory tax. Although the Tennessee business tax at issue there incorporated the federal adjusted gross income, the Tennessee statute added to the base "all income derived from obligations of states other than Tennessee." (Pet. App. 17a [citing *Memphis Bank*, 459 U.S. at 394 & n.3].) As the lower court noted, this resulted in express discrimination: "Because federal AGI already included obligations of the United States . . . , the Tennessee law thus provided an express exemption from taxation for income from bonds issued by the United States and all other states." *Id.* *Kraft* involved an Iowa tax that facially discriminated against foreign commerce: "It is indisputable that the Iowa statute treats dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries." *Id.* at 75. Although Iowa adopted the federal definition of "net income," the federal scheme, unlike Iowa's, avoided discrimination by allowing a credit for taxes paid to foreign countries. The Court therefore found that the tax violated the Foreign Commerce Clause. *Id.* at 82.

Unlike the tax schemes that the Court found invalid in *Memphis Bank* and *Kraft*, Arizona's adoption of federal adjusted gross income as it pertains to mandatory contributions to retirement plans does not inevitably result in

discrimination against federal employees. Rather, both federal and Arizona income tax law distinguish between contributions paid by employees and contributions that are picked up by employers. As the lower court recognized, federal tax law has consistently treated employee contributions differently from employer contributions. (Pet. App. 3a.)

Because the Arizona decision is consistent with this Court's precedents, the Court should deny review.

2. The Arizona Supreme Court Decision Does Not Conflict with Any Other State or Federal Decision.

Although Petitioners acknowledge that twenty-eight States defer the payment of tax on employee contributions that are picked up by their employer, they do not cite to any state or federal decision that is inconsistent with the Arizona Supreme Court decision here. (Pet. at 7; *see also* Jerome Hellerstein & Walter Hellerstein, *State Taxation* § 22.3.04(3)(b) [3d ed. 2004 Supp. No. 1] [discussing the Arizona Supreme Court's decision here and another state case that applies a similar analysis in its post-*Davis* discussion but not noting any conflicting cases].)[11] Given this Court's decision in *Davis* and the state courts' struggle to find appropriate remedies to respond to *Davis*, *id.* § 22.04(3)(a), the absence of any conflicting decisions on

[11] There is a petition for certiorari pending in *Ward v. South Carolina*, U.S. No. 03-1304, 2004 WL 531026 (March 8, 2004). The petition seeks review of the South Carolina Supreme Court's decision in *Ward v. South Carolina*, 590 S.E.2d 30 (S.C. 2003). The South Carolina Supreme Court held that a South Carolina statute that increased state retirement benefits by seven percent in response to *Davis* did not violate 4 U.S.C. § 111.

the issue presented here indicates that this litigation is unique and that the lower court's decision is correct. This Court therefore does not need to grant review.

CONCLUSION

This Court should deny the Petition for Writ of Certiorari.

Respectfully submitted,

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